

Proactive 'distress management'

Planning ahead can mitigate commercial real estate problems

BY JOHN H. SOKUL JR.



We just witnessed the bankruptcy and closing of all Linens 'n Things and Circuit City stores. Other store closings will follow, and several large national mall operators are suffering, including General Growth Properties –

owner of Steeplegate Mall in Concord and Faneuil Hall Marketplace in Boston.

The state of the economy presents serious challenges to the retail real estate industry – challenges that require thoughtful and proactive "distress management."

Approximately \$1.42 trillion in commercial mortgage loans will mature between 2009 and 2012. Refinancing these loans will be difficult due to tenant defaults, vacancies and bankruptcies, declining property values, tougher underwriting standards and the absence of sources of replacement financing. There are no simple solutions to this predicament, but here are some suggestions for borrowers.

Refinancing difficulties

You should review your loan documents and make sure you understand all key terms and requirements. Also, avoid inadvertent defaults and situations that could forfeit non-recourse protections.

Know who has decision-making authority for your loan. In many instances, segments of mortgage loans were sold to different investors, who may now have competing interests. Talk to your lenders early and often. Lenders are more willing to work with cooperative, responsible borrowers. For the moment, lenders appear reluctant to foreclose on shop-

ping centers, due in part to declining values and the significant management responsibilities of a multi-tenant property. Act to extend loans now because this dynamic could change quickly. To "get" an extension, expect to "give" something – a higher interest rate, personal recourse or additional equity or collateral.

Lease renegotiations

As retail sales decline, more tenants are requesting rent reductions or other financial concessions.

Many landlords will work with tenants to keep their properties occupied. However, caution must be exercised. If a landlord provides rent or other concessions to a tenant who subsequently files for bankruptcy, the landlord may have made a bad situation worse.

There are practical measures to mitigate this risk, including important drafting considerations. When dealing with a tenant under financial stress, consult with competent bankruptcy and leasing counsel as early as possible.

Landlord bankruptcies

A landlord bankruptcy, by itself, will not cause a shopping center to close.

In a Chapter 7 bankruptcy, the landlord liquidates its assets, the property is sold (by foreclosure or otherwise) and tenants continue to pay rent. The transition to new ownership is fairly seamless.

In a Chapter 11 bankruptcy, the landlord has time to reorganize and will likely remain in possession and control of the property. If not, a trustee is appointed. Again, tenants are required to pay rent during this process. The landlord is given limited time to assume or reject leases, but must fulfill its responsibilities while this decision is made. Usually the landlord will assume the leases of rent-paying tenants. To assume any lease, the landlord must cure all existing defaults. The decision to assume or reject can happen quickly, so tenants should carefully monitor the bankruptcy proceeding and be ready to document all existing defaults.

Tenant bankruptcies

Tenant bankruptcies can do greater harm to a shopping center than landlord bankruptcies.

The lease is an asset of the tenant's bankruptcy estate. The tenant has a specified time to assume or reject the lease, but must continue to pay rent while deciding. If the tenant rejects the lease, the landlord is entitled to only limited damages. Therefore, unless replacement tenants are available, cash flow will suffer.

Many shopping center leases contain co-tenancy clauses that state that unless a certain amount of space is leased and occupied, tenants are entitled to financial concessions, such as rent reductions and, under certain circumstances, lease termination rights. If enough stores go dark, the ripple effect can be devastating.

Landlords should be aware that once a tenant declares bankruptcy, no further action can be taken to collect rent, terminate the lease or recover possession of the premises. One thing to note is that security deposits are considered property of the tenant's bankruptcy estate and are subject to the automatic stay; letters of credit are not.

In some circumstances, landlords should consider terminating leases before the tenant files for bankruptcy to gain control over the space. If so, make sure all contractual and state law requirements for lease termination are strictly followed.

The bankruptcy code contains provisions specific to shopping centers. For example, if a shopping center tenant assigns its lease, the assignee must comply with all lease requirements related to exclusivity, radius restrictions and use restrictions. Anyone dealing with a shopping center landlord or tenant in bankruptcy should be familiar with these provisions.

A prompt, strategic response to situations caused by financial distress can mitigate negative consequences for all parties. Delay or failure to act can be fatal. **NHR**

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